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# In the Supreme Court of the United States.

OCTOBER TERM, A. D. 1921.

THE UNITED STATES, APPELLANT,
*v.*
C. W. PHELLIS, APPELLEE.
No. 260.

*Appeal from the Court of Claims.*

## BRIEF FOR APPELLANT.

### STATEMENT OF THE CASE.

This is an appeal from a final judgment entered upon petition and answer by the Court of Claims in favor of the appellee in a suit to recover $5,657.95 income taxes alleged to have been illegally assessed and collected for the year 1915, under the provisions of the income-tax law of October 3, 1913, upon $173,750, the value of 500 shares of common stock of E. I. du Pont de Nemours & Company, *a Delaware corporation* (hereinafter referred to as the Delaware corporation), received by the appellee as a dividend by reason of the ownership of 250 shares of common stock in the E. I. du Pont de Nemours Powder Company, *a New Jersey corporation* (hereinafter referred to as the New Jersey corporation).

## I.

### THE STATUTE.

The applicable parts of the income tax act of October 3, 1913 (38 Stat. 114, 166), are as follows:

> A. Subdivision 1. That there shall be levied, assessed, collected and paid annually upon the entire net income arising or accruing from all sources in the preceding calendar year to every citizen of the United States, whether residing at home or abroad, and to every person residing in the United States, though not a citizen thereof, a tax of 1 per centum per annum upon such income, except as hereinafter provided; * * *.
>
> Subdivision 2. In addition to the income tax provided under this section (herein referred to as the normal income tax) there shall be levied, assessed, and collected upon the net income of every individual an additional income tax (herein referred to as the additional tax) of 1 per centum per annum upon the amount by which the total net income exceeds $20,000 and does not exceed $50,000, and 2 per centum per annum upon the amount by which the total net income exceeds $50,000 and does not exceed $75,000, 3 per centum per annum upon the amount by which the total net income exceeds $75,000 and does not exceed $100,000, 4 per centum per annum upon the amount by which the total net income exceeds $100,000 and does not exceed $250,000, 5 per centum per annum upon the amount by which the total net income exceeds $250,000 and does not exceed $500,000, and 6

per centum per annum upon the amount by which the total net income exceeds $500,000. All the provisions of this section relating to individuals who are to be chargeable with the normal income tax, so far as they are applicable and are not inconsistent with this subdivision of paragraph A, shall apply to the levy, assessment, and collection of the additional tax imposed under this section. Every person subject to this additional tax shall, for the purpose of its assessment and collection, make a personal return of his total net income from all sources, corporate or otherwise, for the preceding calendar year, under rules and regulations to be prescribed by the Commissioner of Internal Revenue and approved by the Secretary of the Treasury. * * *

B. That, subject only to such exemptions and deductions as are hereinafter allowed, the net income of a taxable person shall include gains, profits, and income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid, or from professions, vocations, businesses, trade, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in real or personal property, also from interest, rent, dividends, securities, or the transaction of any lawful business carried on for gain or profit, or gains or profits, and income derived from any source whatever, including the income from but not the value of property acquired by gift, bequest, devise, or descent: * * *.

## II.

### THE FACTS.

In September, 1915, and prior thereto, the New Jersey corporation was engaged in the business of manufacturing explosives. At that time its stock and funded debt were as follows:

| | |
|---|---|
| Five per cent mortgage bonds | $1,230,000 |
| Four and one-half per cent 30-year bonds | 14,166,000 |
| Preferred stock (par value $100) | 16,068,600 |
| Common stock (par value $100) | 29,427,100 |
| Total | 60,891,700 |

The world war, which had broken out in 1914, had naturally caused a very great development of the company's business, so much so that in September, 1915, its assets with prior accumulations of profits were valued by the company's directors at $120,000,000. It thus appears that the company, prior to September, 1915, had amassed a surplus of at least $74,505,000, or a surplus over capital stock and funded indebtedness of $59,108,900.

On August 19, 1915, a plan, approved by the board of directors of the New Jersey corporation for the creation of a new corporation, to be known as E. I. du Pont de Nemours & Company, to be incorporated under the laws of the State of Delaware, was submitted to the stockholders of the New Jersey corporation. This plan is too intricate to be summarized and must be examined in full. (See Rec. pp. 9–13.) It proposed the sale of all the plant and other assets of the New Jersey corporation

to a new company with a larger capitalization to be formed under the laws of Delaware. The authorized capital of the new company was to be $240,000,000. Under this plan the Delaware corporation was to purchase all of the assets and assume all the liabilities of the New Jersey corporation and pay therefor in stock amounting in par value to $120,000,000, as follows:

| | |
|---|---|
| Cash | $1,484,100 |
| Debenture stock | 59,661,700 |
| Common stock | 58,854,200 |

The New Jersey corporation, after reserving enough Delaware stock to pay off or retire the funded debt and preferred stock of the New Jersey corporation, *and enough to equal in value its outstanding common stock*, was then to declare and pay *as a dividend* to the holders of its common stock (outstanding $29,427,100) two shares of the common stock of the Delaware corporation for each share held in the New Jersey corporation. This was not an exchange of stock, but a dividend distribution. The New Jersey stockholder retained his stock upon which the dividend was declared. The New Jersey corporation was to redeem its five per cent bonds (outstanding $1,230,000) in cash, and to retire its four and one-half per cent bonds (outstanding $14,166,000) and its preferred stock (outstanding $16,068,600) by offering to their holders debenture stock of the Delaware corporation. (Finding III, Rec. pp. 9–11.) It then kept in its treasury $29,427,100 of the debenture stock of the Delaware corporation, on which cash dividends were paid to the New Jersey stockholders (Find-

ings IV and X, Rec. p. 20), *and the surplus* of the common stock of the Delaware corporation, amounting to $58,854,200—exactly twice as much as the outstanding common stock of the New Jersey corporation—was to be distributed to the latter company's stockholders as a dividend. Each New Jersey stockholder thus received two shares of Delaware stock for each share of New Jersey stock, and, as stated, *he retained his New Jersey stock and that company was to be continued as a going business.*

The plan contemplated not merely a change in corporate ownership, but a reclassification of stockholders with respect to voting power and a large potential increase of capitalization. The New Jersey stockholder would not only have two shares of the Delaware stock for each share of the New Jersey stock which he retained, but his New Jersey stock would itself be in an improved position, by reason of the fact that not only the funded indebtedness was to be retired, but also the outstanding preferred stock of the New Jersey corporation (which, as stated, amounted to $16,068,600) was to be retired. When thus retired, the New Jersey common stockholder, who held one share, instead of owning $\frac{1}{454957}$ of the New Jersey assets, would hold $\frac{1}{294271}$ interest.

Similarly, with reference to the Delaware company, the relative positions of its stockholders were on a different proportionate basis, for its stock was not only greater in amount *but was differently classified.*

The Delaware corporation, as organized, had an authorized capital stock of $240,000,000, divided into

1,500,000 shares of nonvoting debenture stock; 100,000 shares of voting debenture stock; and 800,000 shares of common stock. Of this total authorized capital, the Delaware company, at the time mentioned, only issued 1,200,000 shares, or $120,000,000, all of which was transferred to the New Jersey corporation, as follows: 588,542 shares of the common stock, 100,000 shares of *voting* debenture stock, 496,617 shares of *nonvoting* debenture stock. A relatively small cash payment completed the full purchase money.

The remaining $120,000,000 of authorized capital stock of the Delaware corporation was not issued at the time, but could be issued whenever the directors so decided.

Thus, an individual, who held shares of Delaware stock, did not stand in the same relation to his fellow stockholders in that company as he did with reference to his associate stockholders in the New Jersey corporation, by reason of the different classifications of stock; and this was further complicated by privileges for conversion, under which nonvoting stock might become voting stock.

Two corporations, each to continue in business, were thus proposed, differing in character and purpose.

The sale was agreed to by the stockholders of the New Jersey corporation and a formal agreement was entered into on September 16, 1915, to carry out the terms upon the conditions above indicated.

On October 1, 1915, the New Jersey corporation, by a bill of sale, transferred to the Delaware corporation all of its assets, and the Delaware corporation thereupon paid to the New Jersey corporation the cash payment above referred to and issued to it 588,542 shares of the common stock and 596,617 shares of its debenture stock. (Rec. p 19.)

The New Jersey corporation declared and paid on October 1, 1915, *as a dividend* to each holder of its common stock two shares of the common stock of the Delaware corporation. The New Jersey corporation after the payment of this dividend in specie to its stockholders thereafter held the cash and the debenture stock of the Delaware corporation, and also stock equivalent in amount to the outstanding New Jersey stock, and with these capital assets it has continued to pay cash dividends to its stockholders. (Findings IX and X, Rec. p. 20.)

After the declaration and payment of the dividend in the common stock of the Delaware corporation, the New Jersey corporation continued as a going concern, *is still in existence, and is not in process of liquidation.* (Finding X, Rec. p. 20.)

As stated, it has income yielding assets equal to its entire capital stock. *The distribution of a part of the Delaware stock as a dividend in specie, therefore, was a distribution by the New Jersey corporation of a part of its large surplus.*

On and prior to September 1, 1915, the appellee was the owner of 250 shares of the common stock of the New Jersey corporation (Finding II, Rec. p. 9)

and therefore under the plan above described he received on October 1, 1915, *as a dividend*, 500 shares of the common stock of the Delaware corporation and continued to hold his original 250 shares of the New Jersey corporation (Finding VII, Rec. p. 19).

In his income-tax return for the year 1915, the appellee did not include as income the 500 shares of stock of the Delaware corporation received by him. (Finding XII, Rec. p. 20.) The Commissioner of Internal Revenue ruled that the 500 shares of stock of the Delaware corporation constituted income, and that its market value when acquired by the appellee, October 1, 1915, was $347.50 per share, a total of $173,750. On December 31, 1919, an additional income tax for the year 1915 in the sum of $5,657.95 was assessed against the appellee. On February 20, 1920, the appellee paid the above tax under protest and filed a claim for refund, which was rejected by the Commissioner of Internal Revenue. Suit was thereupon brought by the appellee in the Court of Claims. (Finding XIII, Rec. p. 20–21.)

On March 14, 1921, the Court of Claims gave judgment for the appellee in the sum of $5,657.97 (Rec. p. 21).

On March 17, 1921, an appeal was taken by the United States to this court (Rec. p. 23).

## III.

### ASSIGNMENT OF ERROR.

The Court of Claims erred in holding that the dividend paid by the New Jersey corporation to its stockholders in the stock of the Delaware corpora-

tion was a stock dividend and did not constitute income within the meaning of the sixteenth amendment to the Constitution of the United States and the income tax act of October 3, 1913.

## IV.

### ARGUMENT.

**The stock of the Delaware corporation, distributed as a dividend in specie to the stockholders of the New Jersey corporation, was income and did not constitute, either in form or substance, a stock dividend.**

*In limine*, let me impress upon the court that this was not a case of a company, as in *Eisner* v. *Macomber*, 252 U. S. 189, having a large surplus, which after transferring to capital account was capitalized by the increase of new stock and such new stock distributed among its stockholders. Had the New Jersey company increased its capitalization from $29,427,100 to $120,000,000, to represent the value of their property, and thereupon issued new shares of *its own* stock to its stockholders, there can be no question that, under the decision in *Eisner* v. *Macomber*, it would not be income. In that event, the plaintiff, instead of having certificates for 250 shares, would have had certificates for approximately 1,000 shares. His interest in the property would have been no greater and no less, and the mere duplication of his certificates would not be income within the meaning of the Income Tax Act or of the Constitution. This I recognize and accept.

But what was done, as previously shown in my statement of facts, is something quite different.

The New Jersey corporation had a large surplus, far in excess of its capital stock. When it was acquired does not appear except by inference, but it can be safely assumed that much of it had come to the corporation by the abnormal activities of the first year of the great war. The corporation could have distributed this surplus to its stockholders in many ways.

(1) They could have distributed the vast surplus in cash. If so, it can not be questioned that it would have been income. (2) They could have distributed it in specie, either as securities or, if divisible, tangible property. It is equally clear that such distribution would have been income.

The corporation, however, decided to sell its entire plant to a new corporation. The fact that the new corporation was formed by the managing body of the old corporation and that there was a momentary identity of stockholders—although holding stock in different proportions and relations—can not in any way affect the question. They formed the new corporation in another State and with such franchises as that State granted corporations of this character.

Whether these franchises, as granted by the State of Delaware, were the same or different from the franchise granted to the old company by the State of New Jersey does not appear. Presumably, the promoters of the new company found some advantage in securing a different corporate situs.

Apart from the question of corporate franchises, the new corporation was to be constructed on a different basis from the old. Instead of having a capital issue of $45,495,100, the new corporation had an authorized capital stock of $240,000,000.

The relations between the stockholders *inter sese* were likewise changed. In the old corporation they were classified into common and preferred stock in the proportions that $29,427,100 bears to $16,068,000, respectively, while in the Delaware corporation there were to be three classes of stock, with a substantial variance in power. These holdings, independent of special privileges, were as 800,000 shares of common stock to 1,600,000 shares of debenture stock, and the debenture stock[1] was itself divided between 1,500,000 shares of non-voting debenture stock (which in certain contingencies might thereafter become voting stock) and 100,000 shares of voting stock.

Moreover, the Delaware company retained in its treasury $120,000,000 of stock which was not issued; but, as it was authorized, its possible issue was contemplated. Therefore, potentially, the relative pro-

[1] It is not clear from the statement of facts just what "debenture stock" is. The expression is an English one, and, instead of representing stock in the American sense of the word, it represents in English law an unsecured bond with an absolute obligation to pay principal and interest at fixed times. (Cook on Corporation, Vol. 3, sec. 777.) I assume that the debenture stock now in question simply meant a preferred stock with a fixed cumulative return. But, for the purposes of this argument, it is not important whether the so-called stock was, in fact, a bond or preferred stock in the true sense of the word.

portions of the common owners of this property would be very much changed, and the stockholders greatly augmented in numbers, if and when one-half of the whole capital stock of the new corporation was, as was possible, sold to the public.

The New Jersey company continued its operations as a company. Thenceforth it had the stock in question, out of which it proceeded to retire its bonded indebtedness and, so far as possible, its preferred stock, and held the precise equivalent of its common stock in valuable interest bearing assets, and a large surplus, which it divided among its stockholders.

Nothing prevented the New Jersey company from taking its existing assets, purchasing a new plant, and proceeding with the manufacture and sale of explosives in competition with the Delaware company.

For all legal and practical purposes the two corporations were separate. The New Jersey corporation owed its duty to the State that had created it. The Delaware company owed its duty to the State that had created it.

It is true that, for the time being, the management of both was identical. How long such management would remain identical would depend upon the will of the stockholders, for obviously the stockholders of the New Jersey corporation could, if they chose, select a new management just as the Delaware company could have done. In the case of the Delaware company the possibility of such a change in management would naturally be greatly increased if they sold the unissued capital stock,

being one-half thereof, to the public. It is also true that there was a momentary identity in stockholders, but as the stock was sold on the exchanges, this identity soon ceased.

It may be said that much of this rests upon possibilities. But when we are considering the question as to whether these two corporations are or are not separate entities, the possibilities or potential powers affect the question quite as much as the temporary realities. In other words, I earnestly submit that the technical and, as I think, the substantial difference between these two corporate entities is not destroyed by a temporary identity in the personnel of their management.

Much will be said in the argument of my opponents that in considering this question of identity the court must disregard form and consider substance.

I agree, and need only reply that, judged by substance, these two corporations are separate for all practical purposes, including taxation.

If a creditor of the New Jersey company sued the Delaware company on his debt, he would speedily realize the substantial difference between them.

If an employee of the Delaware company, injured in an accident, would sue the New Jersey company, he would speedily be disillusioned as to their identity.

Are the assets of the Delaware company longer liable for the bonded indebtedness of the New Jersey company?

Could a stockholder of the latter maintain a stockholder's bill against the former?

If the Delaware corporation had become insolvent, could the creditors of the New Jersey corporation ask that they share with the Delaware corporation's creditors in the distribution of its assets?

If the State of New Jersey sued the Delaware company for franchise taxes, or the State of Delaware sued the New Jersey company for such taxes, would not these States *in a matter of taxation* speedily realize that their separation was in substance and not merely in form?

*Is the United States the only taxing power that must be defeated in its claim for taxes on the ground that in substance, though not in form, the two corporations were one?*

My opponents may argue that there is no analogy between these illustrations and the instant case, for the reason that the contingencies referred to in the above questions would arise *in futuro*, whereas the instant case deals with a distribution of securities by the New Jersey company, which took place contemperaneously with the sale of its assets and the payment of the purchase price. I reply that it is not important when these transactions took place, *but what was their essential character.*

Suppose that the New Jersey corporation, having received the stock of the Delaware company in payment of the former's assets, had deferred a distribution of such Delaware stock among the New Jersey stockholders for a year and in the meantime had collected the income from such stock and used it for

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corporate purposes. Would the case be different in principle?

I think not, for it does not matter when the New Jersey corporation distributed the Delaware stock.

The controlling question is, Was this distribution by the New Jersey company of Delaware stock a distribution of surplus earnings, or was it merely a duplication of its own certificates, representing the same proportionate interest in the capital assets of the New Jersey corporation?

It is not denied that, whatever the nature of this dividend may be, it represented a distribution of *surplus* profits, which had been accumulated by the New Jersey corporation, for the capital assets of that corporation remained intact. Moreover, and of greater importance, the Delaware stock represented corporate interests in assets, *which had been severed from the New Jersey corporation by alienation.* Thenceforth the New Jersey stock could not be regarded as representing proportionate interests in the plant and assets thus conveyed. Thenceforth the New Jersey stockholders owned proportionate interests in certain securities of another corporation, which were not only potentially but in fact different from the securities of the New Jersey corporation.

This may be illustrated by an analogous situation. Suppose that the New Jersey corporation had wished to distribute its large surplus, but preferred to do so in specie, and had segregated enough of the assets to represent its existing surplus, say, $75,000,000.

Suppose it had transferred such segregated assets to its stockholders and they had formed a new corporation, which, in turn, purchased these assets.

Can it be questioned that the New Jersey stockholders would have been liable for a tax upon the value of the surplus which they thus received in specie?

If the analogy be true, it necessarily follows that the plant and other assets of the New Jersey corporation were as completely severed from that corporation when it sold them to the Delaware company as if it had distributed such assets, in the illustration used, to the stockholders direct.

This severance of title and this creation of a new corporation can not be obscured because of the temporary identity of the individuals who first constituted one company and then, for their own purposes, incorporated another. It is true that the personality of a corporation is, in a sense, a fiction of the law, but important rights and obligations depend upon the observance of such fiction. A corporation is, however, not a fiction, but an important business instrumentality. The individuals who, owning the New Jersey company, saw fit to form the Delaware company and transform the tangible assets of the former to the latter, believed, and had reason to believe, that there was an advantage in two different corporate personalities. Each such corporate entity conferred upon these individuals valuable rights. The individuals might come and go. Some might

sell their interests and others might die; but the corporations, having potential immortality, continued.

As previously shown, the promoters not merely readjusted finances, but also the relative rights of stockholders, and they acquired distinct and valuable rights in continuing their operations through two different corporate entities. Enjoying these rights, by reason of a legal device, is there injustice in asking them to accept some of the obligations of the so-called fiction of the corporate entity, which is of such value that the whole business of the modern world is largely transacted by the utilization of such instrumentality?

I shall hereafter discuss the many cases which justify my contention that the New Jersey and Delaware corporations, even if formed by the same group of individuals and for a common purpose, are yet for all purposes, including taxation, separate entities. I will now only quote from the opinion of a very able district judge, rendered in two cases which, it is anticipated, will be argued with the instant case. I refer to the cases of *New York Trust Company, Executors, etc.*, v. *Edwards, Collector*, and *United States* v. *John D. Rockefeller*, which, under a somewhat similar state of facts, were decided in favor of the Government by Judge Learned Hand on August 3, 1921. In those cases the taxpayers relied, in part, upon the decision of the Court of Claims in the instant case, but Judge Hand found himself unable to accept such ruling. He said:

*Phellis* v. *United States*, Court of Claims, March, 1921, was a case where all the assets were sold to another corporation, which, omitting irrelevant details, gave its own shares, two for one, to the old stockholders and conveyed its debenture shares to the old company par for par. The result was that the old stockholders had their old shares now represented by the assets of the old corporation, *i. e.*, the debenture shares in the new corporation, and double their original holdings in common shares of the new corporation. Whatever may be the proper answer to the case, with the greatest deference I can not follow the reasoning of the learned judge, now urged upon me as authoritative. That reasoning is that because the joint value of the old and new shares after the transfer was the same as that of the old shares before, there can have been no income to the stockholder. It may, of course, happen that in the case of the distribution of the dividends, the value of the old shares does not fall as much as the value of the dividend, though generally the correspondence is pretty close. It does not make any difference for taxing purposes whether it does or not. The surplus declared as dividend may or may not be represented in the value of the shares, but even though it be fully represented, the dividend becomes income as soon as the stockholder gets it. On his books it may appear as a capital distribution, depending on whether he carries his investment at par. That is not to the point. It was not his property before; it has become such by the declaration of the dividend.

Judge Hand's reasoning seems to me more convincing than that of the Court of Claims in the instant case, which based its conclusion largely upon the inconclusive fact that the market value of the New Jersey and Delaware stock in the stockholders' hands after the dividend was the same as the value of the New Jersey stock before the dividend. This normally happens whenever a corporation declares a dividend. It generally loses in market value by the amount of the dividend, and this is especially true where the dividend is a large or unusual one.

Judge Hand bases his conclusion upon the true ground, viz, that the assets which were represented by the Delaware stock were no longer the property of the New Jersey company. The soundness of his conclusion can be shown by a simple illustration.

Suppose the New Jersey company had declared, out of its surplus, a cash dividend of $58,854,200, or $200 a share, and the stockholders had used this in subscribing to a like amount at par of the stock of the Delaware company, and the Delaware company had then used the $58,854,200 in the purchase of the plant and other assets of the New Jersey company, would not the transaction be in substance the same and would there, in that event, be any doubt about the liability of the New Jersey stockholder to pay a tax upon such cash dividends? In that event he would have, as in the instant case, the stock of the Delaware company.

What matters it whether the Delaware stock, which was issued against the assets purchased from the New

Jersey company, was distributed as a dividend to the New Jersey stockholders, or the New Jersey stockholders first received the cash and then got the Delaware stock? In either event the New Jersey stockholder received cash or its equivalent, for he could sell his Delaware company stock for cash without diminishing his proportionate interest in the capital stock of the New Jersey corporation.

## V.

### THE AUTHORITIES.

It is an established principle that the ownership by one corporation of the stock of another corporation, or the ownership by the stockholders of one corporation of the stock of another corporation, does not destroy the distinct legal entity of the two corporations.

*Pullman's Palace Car Co.* v. *Missouri Pac. Co.*, 115 U. S. 587, 597.

*Peterson* v. *Chicago, R. I. & Pac. Ry. Co.*, 205 U. S. 364, 391.

*Pittsburgh & Buffalo Co.* v. *Duncan et al.*, 232 Fed. 584, 587.

*In re Watertown Paper Co.*, 169 Fed. 252.

*Walker, Coll'r.*, v. *Gulf and Interstate Ry. Co. of Texas*, 269 Fed. 885.

In cases involving taxation the courts have consistently refused to disregard the principle of corporate entity. As was said in *Eisner* v. *Macomber*, 252 U. S. 189, at page 214:

> * * * We must treat the corporation as a substantial entity separate from the stockholder, not only because such is the practical

> fact but because it is only by recognizing such separateness that any dividend—even one paid in money or property—can be regarded as income of the stockholder. Did we regard corporation and stockholders as altogether identical, there would be no income except as the corporation acquired it; and while this would be taxable against the corporation as income under appropriate provisions of law, the individual stockholders could not be separately and additionally taxed with respect to their several shares even when divided, since if there were entire identity between them and the company they could not be regarded as receiving anything from it, any more than if one's money were to be removed from one pocket to another.

The decisions of the Supreme Court in *Southern Pacific Ry. Co.* v. *Lowe* (247 U. S. 330) and *Gulf Oil Corporation* v. *Lewellyn* (248 U. S. 71) are clearly distinguishable from the instant case.

In *Southern Pacific Ry. Co.* v. *Lowe*, the Southern Pacific Company prior to March 1, 1913, owned all of the stock of the Central Pacific Railway Company and "*was in the actual physical possession of the railroads and all other assets*" and "*in charge of its operations,*" and "*acted as cashier and banker of the entire system.*" The Central Pacific kept no bank account and if it needed money for additions or betterments or otherwise, the necessary funds were advanced by the Southern Pacific. In short, the Central Pacific was a mere name, and the court held that the Southern Pacific had the full ownership and control of the company

and its property and assets. The court expressly limited its opinion to the case before it, saying that it rested on "its very peculiar facts."

This case is distinguished in *Peabody* v. *Eisner* (247 U. S. 347), on page 349, as follows:

> * * * *Southern Pacific Co.* v. *Lowe*, has been reversed this day, ante 330, but only upon the ground that the Central Pacific Railway Company, which paid the dividend, and the Southern Pacific Company, which received it, were in substance identical corporations because of the *complete ownership* and control which the latter possessed over the former as stockholder and in other capacities, so that while the two companies were separate legal entities, yet in fact and for all practical purposes the former was but a part of the latter, acting merely as its agent and subject in all things to its direction and control; and for the further reason *that the funds represented by the dividend were in the actual possession and control of the Southern Pacific Company as well before as after the declaration of the dividend.*

See also the distinction made in *Lynch* v. *Hornby* (247 U. S. 339), on page 346.

In the *Gulf Oil Corporation case*, 248 U. S. 71, the Gulf Oil Company "was a holding company *owning all the stock* in the other corporations concerned excepting the qualifying shares held by directors. These companies with others *constituted a single enterprise.*"

There is little similarity between the facts in these cases and the facts in the instant case. The Delaware corporation does not own any, much less all of the, stock

in the New Jersey corporation, and while the New Jersey corporation *momentarily* owned all of the *issued* stock of the Delaware corporation, yet it made an immediate division of it, (1) reserving for its treasury the equivalent of its capital stock, (2) distributing to its bondholders and preferred stockholders sufficient stock to pay the one and retire the other, and (3) distributing the remainder of the stock among its individual stockholders. The Delaware corporation was organized for a definite and distinct purpose, and the New Jersey corporation likewise continued its existence for a definite and distinct purpose. It is plain that there was not a merger of the two, or that one was merely the reorganization of the other. Both corporations are still in existence, and each has its own distinct assets and liabilities.

The case of *Southern Pacific Company* v. *Lowe* would only be analogous and its doctrine applicable if the New Jersey corporation owned *all* the stock of the Delaware corporation, conducted *all* the operations of the business, had possesssion of *all* the funds, and plant, and simply declared a dividend payable solely to itself.

It is obvious that no such case is presented here. Each company has its own management, its own funds and property, conducts it own operations, declares its own dividends, and pays them to its own stockholders, who, if temporarily identical on October 1, 1915, ceased to be identical, as the stocks of each corporation were bought and sold on the market. The stock-

holders of the New Jersey corporation, therefore, received a dividend of stock in a new, distinct, and separate corporation.

## VI.

### PEABODY V. EISNER IS CONTROLLING.

Bearing in mind the difference in corporate entity between the New Jersey corporation and the Delaware corporation, and the fact that the property of the New Jersey corporation was sold for stock in the Delaware corporation, and that part of such stock was distributed to the stockholders of the New Jersey corporation as a dividend, the case of *Peabody* v. *Eisner* (247 U. S. 347), holding that where a corporation pays a dividend in the stock of *another* corporation such dividend is not a stock dividend but is a distribution in specie of a portion of the assets of the declaring corporation, is controlling.

In that case the Union Pacific Railroad, prior to March 1, 1913, and thereafter, had large holdings of the common and preferred stocks of the Baltimore & Ohio Railroad. On March 2, 1914, the Union Pacific declared a dividend payable in these stocks. In distinguishing the case of *Towne* v. *Eisner* (245 U. S. 418), the court said:

> It hardly is necessary to say that this case is not ruled by our decision in *Towne* v. *Eisner*, since the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific, and is to be governed for all present purposes by the same rule applicable to the

> distribution of a like value of money. It is controlled by *Lynch* v. *Hornby*, this day decided, *ante*, 339. (*Peabody* v. *Eisner*, 247 U. S. 347, 349–350.)

The principle laid down in *Peabody* v. *Eisner* (*supra*) was approved in *Eisner* v. *Macomber* in the following language:

> The Government's reliance upon the supposed analogy between a dividend of the corporation's own shares *and one made by distributing shares owned by it in the stock of another company*, calls for no comment beyond the statement that the latter distributes assets of the company among the shareholders while the former does not; and for no citation of authority except *Peabody* v. *Eisner*, 247 U. S. 347, 349–350. (*Eisner* v. *Macomber*, 252 U. S. 189, 215.)

The case of *Eisner* v. *Macomber* (252 U. S. 189) defines a stock dividend as one paid by a corporation *in its own stock*. As showing the nature of a stock dividend, the court says, at page 211:

> A "stock dividend" shows that the company's accumulated profits have been capitalized, instead of distributed to the stockholders or retained as surplus available for distribution in money or in kind should opportunity offer. Far from being a realization of profits of the stockholder, it tends rather to postpone such realization, in that the fund represented by the new stock has been transferred from surplus to capital, and no longer is available for actual distribution.

> The essential and controlling fact is that the stockholder has received nothing out of the company's assets for his separate use and benefit; on the contrary, every dollar of his original investment, together with whatever accretions and accumulations have resulted from employment of his money and that of the other stockholders in the business of the company, still remains the property of the company, and subject to business risks which may result in wiping out the entire investment.

In referring to the case of *Towne* v. *Eisner* (245 U. S. 418, 426) the court, in the *Macomber case,* says:

> Notwithstanding the thoughtful discussion that the case received below we can not doubt that the dividend was capital as well for the purposes of the income-tax law as for distribution between tenant for life and remainderman. What was said by this court upon the latter question is equally true for the former: "A stock dividend really takes nothing from the property of the corporation, and adds nothing to the interests of the shareholders. Its property is not diminished, and their interests are not increased. * * * The proportional interest of each shareholder remains the same. The only change is in the evidence which represents that interest, the new shares and the original shares together representing the same proportional interest that the original shares represented before the issue of the new ones." *Gibbons* v. *Mahon,* 136 U. S. 549, 559, 560. In short, the corporation is no poorer

> and the stockholder is no richer than they were before. *Logan County* v. *United States*, 169 U. S. 255, 261. (*Eisner* v. *Macomber*, 252 U. S. 189, 202–203.)

The *Macomber case* thus establishes with finality the principle that the payment of a dividend *in the stock of another corporation* is not a stock dividend.

The Supreme Court in that case states the salient characteristics of a stock dividend to be:

1. That it takes nothing from the property of the declaring corporation, and adds nothing to the interests of the stockholders;

2. That the evidence representing their interest has merely been split up into a different number of shares.

Let us apply these tests to the instant case.

1. In the case at bar the New Jersey corporation is poorer to the extent of the dividend declared in the permanent severance ftom its assets of valuable interest-bearing securities, which were thus transferred to the stockholders of the New Jersey corporation as individual owners and they in turn are richer in their power to dispose of these valuable securities as their own property.

(2) Applying the second test, something more has happened to the New Jersey stockholder than the mere duplication of his certificates of its stock. Without losing his proportionate interest in the capital stock of the New Jersey corporation, he has acquired valuable securities, being shares of another corporation, which, if he will, he can immediately con-

vert into cash. It is true that the assets of the New Jersey corporation have been diminished, and that therefore his New Jersey stock no longer has the same value, but this is always the case where a corporation divides its profits by declaration of dividends, whether in cash or specie. The unescapable fact is that the New Jersey stockholder thus received a portion of the great surplus of undivided profits, to which he had doubtless been looking with longing eyes as they rolled up with unprecedented rapidity. The melon of a vast surplus had been cut. It matters not whether the stockholder received it in tangible property, valuable securities, or cash. He had reaped the reward of his waiting. Without diminishing his proportionate interest in the New Jersey company, he could sell the stock in the Delaware corporation, which he received as a dividend, for the sum of $347.50 per share. In this way, the plaintiff, having awaited the cutting of an exceptionally juicy melon, received upon his holding of 250 shares, *which he still retained*, the equivalent in cash of $173,750, and I confess my inability to see why he should not pay his income tax as well as any other stockholder, who receives a dividend payable in cash, or the equivalent thereof.

## VII.

**The dividend in the present case was not a liquidation dividend.**

The admitted facts in this case show that the New Jersey corporation retained sufficient assets represented by the debenture stock of the Delaware corporation

to equal the par value of the New Jersey corporation's outstanding common stock. There was no retirement of the capital stock of the New Jersey corporation. The corporation continued to function as a corporation, receiving income and paying dividends. A liquidating dividend necessitates a retirement of stock outstanding and the Court of Claims has found that the New Jersey corporation has not retired its common stock and has an equivalent amount in interest-bearing assets.

> The New Jersey corporation, after the distribution of the stock of the Delaware corporation, continued as a going concern and is still in existence * * * and is not in process of liquidation. (Finding X, Rec. p. 20.)

The case of *Lynch* v. *Turrish* (247 U. S. 221), therefore, has no application to the facts in the present case. As was said by the court in that case:

> And in determining the application of the statute to Turrish we must keep in mind that on the admitted facts the distribution received by him from the Payette Company manifestly was a single and final dividend *in liquidation of the entire assets and business* of the company, a return to him of the value of his stock upon the surrender of his entire interest in the company, and at a price that represented its intrinsic value at and before March 1, 1913, when the act took effect. (Italics ours.) (*Lynch* v. *Turrish*, 247 U. S. 221, 226.)

The limitations of the *Turrish case* are clearly brought out in the case of *Lynch* v. *Hornby* (247 U. S.

339), in which it was held that a dividend, even though extraordinary in amount and derived from a surplus of corporate assets existing before March 1, 1913, was nevertheless taxable, the court saying:

> The case was tried in the District Court and argued in the Circuit Court of Appeals, together with *Lynch* v. *Turrish* (236 Fed. Rep. 653), and was treated as presenting substantially the same question upon the merits. In our opinion it is distinguishable from the Turrish case, where the distribution in question was a single and final dividend received by Turrish from the Payette Company in liquidation of the entire assets and business of the company and a return to him of the value of his stock upon the surrender of his entire interest in the company, at a price that represented its intrinsic value at and before March 1, 1913, when the Income Tax Act took effect.
>
> In the present case there was no winding up or liquidation of the Cloquet Lumber Company, nor any surrender of Hornby's stock. He was but one of many stockholders, and had but the ordinary stockholder's interest in the capital and surplus of the company, that is, a right to have them devoted to the proper business of the corporation and to receive from the current earnings or accumulated surplus such dividends as the directors in their discretion might declare. *Gibbons* v. *Mahon*, 136 U. S. 549, 557 * * *. (*Lynch* v. *Hornby*, 247 U. S. 339, 341.)

In the *Hornby case* the court distinguishes the cases of *Lynch* v. *Turrish* and *Southern Pacific* v. *Lowe*, as follows:

> Of course we are dealing here with the ordinary stockholder receiving dividends declared in the ordinary way of business. *Lynch* v. *Turrish* and *Southern Pacific Co.* v. *Lowe*, rest upon their special facts and are plainly distinguishable. (P. 346.)

## VIII.

### DIMINUTION OF MARKET VALUE UNIMPORTANT.

The Court of Claims was, I respectfully submit, led astray in this case by the seeming hardship of the accidental circumstance that the value of the plaintiff's New Jersey stock before the payment of the dividend was precisely the same as the value of his New Jersey and Delaware holdings after the payment of the dividend. The court says:

> The figures indisputably demonstrate that by the transaction the plaintiff did not gain or lose a penny.

The Court of Claims adds:

> As a matter of fact if the position of the defendants is to be sustained the plaintiff herein instead of receiving an income from the transaction loses $5,657.97, which he must pay from gains derived from a source other than the one in controversy, or out of his original investment.

Impressed by this the Court of Claims argues:

> It seems incredible that Congress intended to tax as income a business transaction which admittedly produced no gain, no profit, and hence no income. If any income had accrued to the plaintiff by reason of the sale and exchange made it would doubtless be taxable.

This court has shown the unsoundness of this reasoning when it answered the same argument in *Lynch* v. *Hornby, supra*, as follows:

> We do not overlook the fact that every dividend distribution diminishes by just so much the assets of the corporation and, in a theoretical sense, reduces the intrinsic value of the stock. But at the same time it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares. In our opinion Congress laid hold of dividends paid in the ordinary course as *de facto* income of the stockholder, *without regard to the ultimate effect upon the corporation resulting from their payment.*

Had the fallacious argument of the Court of Claims as to the net pecuniary result to the stockholder of the declaration of the dividend been of any importance the Supreme Court would have decided the case of *Peabody* v. *Eisner*, 247 U. S. 347, differently, for in that case the moment the Union Pacific Railroad Company distributed the Baltimore and Ohio stock the shares of the former dropped in the market by

the precise amount of the value of the latter, and thus the Union Pacific stockholder found himself no richer and no poorer by reason of such payment. Every taxpayer, whose income is from stock investments, generally finds himself after the payment of his dividend momentarily no better off, for the new valuation of his stock is the old amount less the dividend. The theory upon which the Court of Claims ruled the instant case would mean that the Government of the United States has erroneously collected hundreds of millions of dollars from stockholders who paid taxes on dividends and who by reason of temporary fluctuation on the stock exchange found themselves after the receipt of the dividend no richer and no poorer.

Every dividend, except a stock dividend, "diminishes by just so much the assets of a corporation." Fluctuation in market value is not the criterion which determines whether income has been derived from capital, but the segregation of corporate assets, which before segregation represented only an inchoate right of the stockholder, does determine whether income has been received. (See *Eisner* v. *Macomber*, p. 208).

The circumstances, under which surplus is severed and thereby something is lost to the company and something is gained by the stockholder, were stated by this court as follows:

> * * * If profits have been made and not divided they create additional bookkeeping liabilities under the head of "profit and

> loss," "undivided profits," "surplus account," or the like. None of these, however, gives to the stockholders as a body, much less to any one of them, either a claim against the going concern for any particular sum of money, or a right to any particular portion of the assets or any share in them unless or until the directors conclude that dividends shall be made and a part of the company's assets segregated from the common fund for the purpose. The dividend normally is payable in money, under exceptional circumstances in some other divisible property; and when so paid, then only (excluding, of course, a possible advantageous sale of his stock or winding up of the company) does the stockholder realize a profit or gain which he owes his separate property, and thus derive income from the capital that he or his predecessor has invested. (*Eisner* v. *Macomber*, 252 U. S. 189, 209.)

The dividend received by the stockholders of the New Jersey corporation represented such a segregation from the surplus profits of the New Jersey corporation, and the realization thereon by the stockholder was income. The dividend came *ab extra* and constituted "a gain derived from capital"—"income derived from any source whatever."

It is immaterial whether the property sold by the New Jersey corporation to the Delaware corporation was acquired prior to March 1, 1913, or after March 1, 1913. This principle was settled by the case of *Lynch* v. *Hornby* (247 U. S. 339).

## IX.

### THE ARGUMENT FROM HARDSHIP.

The argument, which evidently most deeply impressed the Court of Claims, and which probably will be pressed upon this court with the greatest insistence, is the alleged hardship upon the stockholder of the New Jersey company, who, having on September 30, 1915, 250 shares of stock of that corporation, which were valued at $795 per share, found, after he had received his dividend in the Delaware stock, that his investment had shrunk from $795 per share to $100 per share. It will be claimed that this demonstrates that it was, in fact, a tax upon the capital investment of the stockholder. It will probably be argued that to pay the income tax upon the stockholder's dividend results in an actual diminution of his so-called capital investment.

In reply, I submit that we are dealing with the case of a distribution of profits which were unprecedented in size, and that the case in principle would not differ whether the dividend was, as in this case, disproportionate to the par value of the stock and the case where a dividend was, as is usual with most dividends, small in proportion to such par value.

"Hard cases make bad law," and this court should be very slow in asserting a principle with respect to a dividend of unusual size, which would necessarily be applicable to a very much smaller dividend. *The hardship, however, is more apparent than real.*

The record does not disclose what the New Jersey stock cost the plaintiff. Let us assume the most

favorable situation with respect to the plaintiff's claim by assuming that Phellis had paid, shortly before the declaration of the dividend, the full market price of $795 per share. In that event, it is undoubtedly true that with the declaration of this dividend his stock had immediately shrunk to $100 per share. Nevertheless, it was within his power, and for aught that the record discloses he exercised that power, to sell his stock, after the stock sold ex-dividend, for the new market value of $100.

In that event, he did not suffer any hardship whatever, for in making up his income account on the debit side he would account for his share of the accumulated profits by admitting a receipt of $695 in value from dividends, and on the credit side he would get a credit for the precise amount of such shrinkage in the value of his stock. Thus he would pay no tax at all. How, then, was he injured?

As the Phellis case will necessarily be applicable to many other stockholders of the New Jersey corporation, it is inconceivable that the very astute business men, who thus were able by the exigencies of the war to roll up this prodigious snowball of profits, did not, if they had paid a sum for the stock which represented its original value plus these great profits, sell their stock to establish a loss which would counterbalance their particular slice of this very juicy melon.

Let us suppose, on the other hand, that Phellis had been an original purchaser of the stock at or near par, or let us take the price of the stock as it was on March 1, 1913, when it was selling at about $130 a

share.[1] Between the period of his original investment at $100 a share, or between the period when his stock was valued for taxation purposes at $130 a share, he had been the fortunate possessor of shares of stock which, through the amassing of war profits, had earned approximately six times the value of his stock. Unquestionably he had thus profited by this great accumulation of profits. It is true that until the company declared a dividend he could not be taxed upon his share of this vast accumulation of profits, even though his stock mounted by leaps and bounds in a period of less than two years from $100 a share, or, as of March 1, 1913, $130 per share, to $795 a share. If he had sold his stock prior to the declaration of this large dividend, he would unquestionably have been obliged to account and pay a tax upon the great appreciation in the value of the stock due to these great profits. When, however, he preferred to hold the stock to await the "cutting of the melon," and when the melon was cut and he thus received, as a dividend, his slice of these accumulated profits, amounting to $695 per share, *what hardship is there in his being asked to pay a tax upon such war profits?*

## X.

### TOWNE V. EISNER, DISTINGUISHED.

In commenting upon the *Towne case* in *Eisner* v. *Macomber*, this court said:

[1] The record does not disclose what the value of the stock was on March 1, 1913. I have taken the figure from stock exchange statistics. If this is disputed, the figure can be taken not as the statement of a fact but as an illustration of possible value at that time.

> * * * In *Peabody* v. *Eisner* (pp. 349–350) we observed that the decision of the District Court in *Towne* v. *Eisner* had been reversed "only upon the ground that it related to a stock dividend which in fact took nothing from the property of the corporation and added nothing to the interest of the shareholder, but merely changed the evidence which represented that interest"; and we distinguished the *Peabody case* from the *Towne case* upon the ground that "the dividend of Baltimore & Ohio shares was not a stock dividend but a distribution *in specie* of a portion of the assets of the Union Pacific."

If the New Jersey corporation's property had been sold for cash and the amount over and above that represented by its capital stock distributed as a cash dividend, taxable income would undoubtedly have been received by the stockholders of the New Jersey corporation. *Lynch* v. *Hornby, supra.*

This court has recently recognized the doctrine that a sale of corporate assets for stock of another corporation, when such stock has a wide and general market, is the equivalent of a sale for cash. (*Geddes* v. *Anaconda Mining Company*, 254 U. S. 590, 598.)

In that case, this court said:

> It would be a reproach to the law to invalidate a sale otherwise valid because not made for money, when it is made for stock which a stockholder receiving it may at once, in the New York or other general market, convert into an adequate cash consideration for what his holdings were in the corporate property.

Therefore, in the instant case where the assets of the New Jersey corporation were sold for stock of the Delaware corporation, and such stock had an ascertained cash value, taxable income was received by the stockholders of the New Jersey corporation upon the declaration and payment to them of the dividend in stock of the Delaware corporation. They could immediately convert it into cash. Thus they received in the equivalent of cash their share of a huge surplus of war profits. Why should they not pay an income tax thereon?

## XI.

### WAR PROFITS.

The plaintiff below, in his petition in the Court of Claims, appended an exhibit wherein it is stated that included in the corporate assets of the New Jersey company was "a large surplus accumulated practically entirely after the outbreak of the European war." (Rec., p. 7.) Even if this had not suggested to the court the nature of these profits thus divided as dividends, this court, having in mind the history of the times, would not be oblivious to the fact that in this case it has under consideration a tax upon a dividend arising from war profits.

This is not mentioned to suggest a prejudice against this form of corporate earnings, for, if the du Pont Powder Company made great profits by reason of the terrible exigencies of the war, they likewise rendered an inestimable service, for it may be true that the World War would have been

lost had it not been for the du Pont Powder Company, the granaries of the Northwest, and the steel mills of Bethlehem and Pittsburgh.

The fact is only mentioned because in this and other cases to be argued herewith the suggestion has been made that this dividend, because it was abnormal in size and not in its nature "recurrent," should in some way on that account escape taxation.

Freely conceding that the du Pont Powder Company was fully entitled to all it made out of the war, it still remains that its shareholders should be willing, as all other citizens, to pay a tax upon their dividends.

*The plaintiff and all his fellow stockholders had received in valuable securities, immediately convertible into cash, their share of these huge war profits, and it would seem unconscionable to permit them, merely because their dividends were in specie and not in cash, to escape their fair share of the burdens of taxation.*

## XII.

### IMPORTANCE OF DECISION.

This case involves many millions of dollars to the Treasury of the United States in its application to the stockholders of this and many other corporations, but the *principle* involved, as bearing upon the honest collection of taxes upon dividends, is even more important.

I have not impeached the good faith of the du Pont Company transaction, or suggested that the transaction under consideration was a mere method of evading taxes, for there is nothing in the record to justify such inference and I do not believe it. The

good faith of the management of the du Pont Powder Company is therefore conceded.

Nevertheless, the fact remains that, if their contention should prevail, an easy method has been provided to enable corporations to distribute their surplus among their stockholders in the equivalent of cash without the stockholders paying their fair share of the burdens of taxation. A corporation need only transfer its surplus to another corporation and take in return its stock and then distribute it among its stockholders.

For example, the Standard Oil Company of New Jersey could transfer the whole or part of its huge surplus to the Standard Oil Company of California, receive a new issue of the latter company's stock and distribute it as a dividend among the former company's stockholders, and they would be in the happy position of having securities that are as good as Government bonds without the necessity of paying any taxes and without diminishing their stockholding interest in the New Jersey company.

> Can such things be,
> And overcome us like a summer's cloud,
> Without our special wonder?

Respectfully submitted.

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